RECORDING INDUSTRY PRACTICES

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The California Senate Select Committee on the Entertainment Industry has now held three hearings on recording industry practices. The first one on the California's Seven Year Rule and the exception obtained by the recording industry, resulted in the introduction of legislation to repeal the exception. Extensive negotiations between the Recording Artists Coalition (RAC) and the Recording Industry Association of America (RIAA) failed to produce an agreement. That bill was put on hold and will be revisited in the upcoming legislative session. The last two, done jointly with the California Senate Judiciary Committee, focused on record company accounting practices. There was testimony at each of the hearings from Artists, their lawyers and managers, the RIAA as well as representatives from each of the five major record companies, Bertlesmann Music Group (BMG), EMI Record Group (EMI), Sony Music Group (SONY), Universal Music Group (UMG) and Warner Music Group (WMG),

Much like the public generally dislikes politicians, but love their individual representatives, Artists have respect for their record company handlers, but distrust the companies themselves and the system they operate under. They see themselves as victims of an indentured servitude system designed to keep them perpetually indebted to the companies who also own the product of their labor. Some artists expressed gratitude for the initial investments made by the record companies in their talent, but feel cheated by their meager share of the proceeds when the gamble pays off. One artist's representative went so far as to accuse the record companies of running a continuing criminal enterprise.

The record companies are genuinely appalled at the accusations and feel that they are the true victims. They are insulted that after making multi-million dollar investments in artists, few of which actually pay off, that they are then held hostage by the successful few. They claim they are forced to pay large advances and otherwise accede to whims of spoiled, pampered artists who make millions, yet whine that they are oppressed. They further complain that artists should be helping fight the real enemy of digital piracy, instead of accusing record companies of thievery.

When confronted by the accusations from auditors that all royalty statements under reported royalties due to the artists, representatives from all five major record conglomerates denied any wrongdoing. I was reminded of the tobacco executives standing in front of Congress and swearing that they did not believe tobacco was harmful to ones health.

No matter whom, you believe there is clearly dysfunction in the relationship between artist and record company.

For many years, artists preferred to leave advocacy to the record companies and their trade association, the RIAA. This fit the artists' perception of themselves as artists and not business people. The artists stayed in the background until the RIAA needed to bring some star power to an issue. The artists were then trotted out for maximum effect and then sent back to their creative cocoons. This worked effectively until the interests of the record companies diverged from those of the artists.

In 1987, the record companies, through legislation, got the aforementioned exception from the Seven Year Rule in California. This is one of the first instances where the record companies' interests clearly diverged from those of the artists. The artists put forth no effective opposition. While some artist's representatives and the relevant labor unions opposed the legislation creating the exemption, the artists did not have an effective lobbying organization. Not one artist testified for or even participated in the opposition.

Then in 2000, the record companies again, like thieves in the night, put an amendment in a rather innocuous bill before Congress that would have taken away artists' ownership of their copyrights in the future. This was the so-called "Work for Hire Amendment". Alas, the record companies awoke the sleeping giant. A slew of artists lead by Don Henley and Sheryl Crow formed the Recording Artists Coalition, went to Washington and had the bill overturned the very next year. No small feat in the pantheon of legislative work, which usually takes years.

Then the RIAA tried to sneak language into a bankruptcy bill before Congress that would have negatively affected artists. Again they were found out, and the amendment was removed from the final bill. In these cases, artists' interests were not just overlooked; they were purposefully trampled on by the very people who were previously thought to be protecting artists. These late night attempts at thievery have contributed to the distrust and dysfunction in the artist/record company relationship, and have spawned artists rights groups like the Recording Artists Coalition and has a sparked a fire in the artists unions such as the American Federation of Television and Radio Artists (AFTRA) and the American Federation of Musicians (AFM).

This all must be read in the context of a crisis in the recording industry. Sales are down and piracy is rampant with many of the most popular songs and albums available over the Internet for free. Artists and record companies need each other. The artists need the record companies to invest in and market their music. The fantasy of a direct relationship with the fan/consumer using technology and the Internet is just that, a fantasy. Record companies obviously need the artists to make music, but also to be their allies in fighting piracy and the various battles with the high tech industry as evidence by the fight over royalties for streaming music over the Internet. Artists are the best representatives for the industry. They are obviously experts at communicating. The companies need artists to help them communicate with fans and customers to determine what the best business models and formats are to deal with current and future technology changes.

Aside from the merits of the various issues, which will be discussed here, one of the most significant issues from the artist perspective is trust. The RIAA has become expert at the late night amendment and at managing the legislative process to their benefit. Normally this is considered a good trait for a trade association. In cases where there is a clear separation of interests, like pro-choice vs. anti-choice, pro-gun vs. anti-gun, this behavior is necessary for survival. To the victor go the spoils. However, in the case of artist related issues, the artists and the record companies are supposed to be allies and partners. It is as if one spouse began secretly moving assets in order to benefit him or herself to the detriment of the other spouse. Upon discovery, it is bound to generate resentment, anger and possibly revolt.

There are actually two ongoing issues upon which the artists and the companies fundamentally disagree: the Seven Year Rule and Accounting Practices. Once these two issues are solved, artist and record companies can join together to fight their mutual enemies.

One of my colleagues, Jim Battin, expressed at the last hearing, a warning to the record labels and the artists to be wary of legislative solutions to the problems of an industry whose inner working are a mystery to most. Such situations provide the possibility of legislatively imposed solutions that make neither party happy. Some issues like the Seven Year Rule and copyright issues are statutory in nature and must be solved by legislation. Others, like the structure and nature of contracts are less appropriate, but nevertheless subject to legislative solutions. Still other issues like the penalties for certain type of behavior or breaches of record contracts are appropriate for legislative solutions.

SEVEN YEAR RULE

Sections 2855 (b) of the California Labor code provides an exception for recording contracts which serves to virtually remove any limits on their length. With the average recording contract for five to seven albums, and marketing cycles of two years or more, recording contracts can reach 25 years. Record companies argue that artists are able to renegotiate if they are successful and are well paid. However, even with the availability of renegotiation, without there being a limit to the contracts, artists are never able to receive their “full value in marketplace” as the courts mandated in Olivia de Havilland vs. Warner Brothers, because they are still under contract to the record company during these renegotiations. The record company is in the best position, because they don’t have to do anything. Even though successful artists can be paid very well, “a gilded cage is a cage nevertheless”.

It seems clear, that there should be some limit to recording contracts. Otherwise a record contract is a well-paid form of indentured servitude… …exactly what the Seven Year Rule was designed to prevent.

From the early part of the last century, up to 1987, California believed seven years to be an appropriate time period. We should remove the 1987 exception. Record companies will not lose their superstar artists. With control over the artist’s catalog, the incumbent record company can always make the most lucrative deal. Additionally, they would have the opportunity to pick up established artists from other companies. Because these artists would be able to get their full value in the marketplace, the companies may pay more for the proven artists. However, the astute record executive will also be able to find the underappreciated pearls. Carlos Santana is just the latest example of an artist who career was reinvigorated by working with a fresh creative team at a new record company. The comeback album of an established artist on a new record company is a historic staple of the record business.

Because it is statutory in nature, this is an issue that must be solved by legislation. The issue will be revisited by the California legislature in the coming year. While the Seven Year Rule is currently a part of California law, it will be introduced by the Speaker of the New York Assembly in the coming legislative session and is currently being considered for introduction in other states, such as Georgia, Texas, Florida and Tennessee.

ACCOUNTING PRACTICES

The accounting practices controversy really has a number of sub-categories. These include the structure of contracts, recoupment, the lack of penalties for underpayment, restrictions on the right to audit, and royalty provisions that are purposefully vague and subject to slanted interpretation.

Recoupment

One of the biggest complaints of artists is the structure of record contracts such that most of the major costs including the costs of recording the record are recouped against the artist's royalties. Further, at least half of the costs of videos and other major promotional costs are charged against the artists share. As such, for a modestly successful record, while the record company makes the upfront investment and takes the financial risk, the artist actually pays for most of the costs. This is seen by artists as patently unfair, particularly considering that the record companies own the fruits of the artists' labor, the master recordings. It is as if one made mortgage payments but never took title to the house. No other industry with royalty artists operates this way.

Government is usually loath to actually dictate the terms of contracts between private parties, but when the relative leverage of the parties significantly favors one party; government often steps in to protect the party with the least leverage.

Record companies should consider going back to the old practice of separating the personal advance and recording/video/promotion and marketing costs. Contracts should be structured such that the personal advance is recouped against the artist's royalties, but recording costs under a certain amount, say $250,000, are not recouped. Videos, major marketing and independent promotion costs could be treated the same. This would increase royalty payments to successful artists, but more importantly would also encourage artists to be more efficient and would significantly reduce the multi-million dollar upfront investments made in artists by the company. This in turn reduces the record company's risk, reduces the amounts lost on unsuccessful artists, and increases the record company's bottom line. This creates a positive atmosphere for everyone involved. This reduced risk would also make up for any increased payments due to the reversion back to the original Seven Year Rule.

There will still be selfish and overindulgent artists, but they would pay the price for such overindulgence. Serious dedicated artists, who show gratitude for the chance that record companies are giving them and show respect for the amount of the record company investment would be rewarded.

Royalty Accounting

In our legislative hearings it was clear that artists feel they are being systematically cheated out of their royalties. They feel that after they are forced to sign contracts that favor the record company, they are not even paid the royalties they are due under the contract.

The record companies counter that the contracts are negotiated on behalf of artists by very skilled lawyers who would not have their clients sign substandard contracts and that they accurately pay all royalties due.

When questioned, top artists' lawyers unanimously stated that even with their high-powered client lists they do not have the leverage when negotiating for a new artist to change the contract offered other than marginally. Given that the five major companies release over 90% of commercial music, the artist is faced with signing the standard agreement or giving up a career as a music artist. Most sign the agreement. This dynamic makes it even more distasteful to then not get the full amount due under the contract. Even when artists audit, they are forced by their contracts to go to court in order to get the full amount due. As a result they often settle for some amount significantly less than the total amount due. This generates even more resentment among the artists. They have to pay for an audit and go to court in order get what they were rightfully due anyway. They frequently end up with significantly less than was due.

While artists' auditors stated that all audits find underpayment, it is also true that they are paid to find such underpayments. They also self-select as to which audits actually proceed. However it is clear that few artists can afford to audit. There are huge numbers of royalty artists whose royalties are significant, but do not rise to level that they can afford to pay a minimum $15,000 retainer to initiate an audit.

Whichever side you believe, there is clearly a problem. Even if you take the record companies at their word, at best they have serious perception problem that is poisoning the well. If one spouse truly believes the other is cheating, the truth of the matter irrelevant. Even an unfounded belief will poison the marriage creating a dysfunctional family. It is incumbent on the accused spouse if he or she wants the marriage to work to assure the other spouse of his or her fidelity.

The hearings showed that at the very least there is purposeful neglect on the part of the record company accounting departments. Under questioning at the last hearing royalty accountants at the record companies admitted that there are "royalty policies" which often override the provisions of an artist's contact. These policies surely favor the record company more than the artists. With companies issuing sometimes tens of thousand of statements each period, it is understandably complicated to take into account the nuances detailed in the language of each contract. But that is what they are supposed to do. Indeed that is what they have promised by contract that they would do. In reality, record companies have traded away accurate royalty accounting to artists for operational efficiency in their accounting departments.

It appears many artists are routinely underpaid royalties they are rightfully due. While superstars can afford to audit and find these discrepancies, the 95% of artist who can't or don't audit or for whom the amounts don't justify an audit are taken advantage of. This results in windfalls for the record companies. The recording contract will also usually state that if the artist does not file notice of an audit or claim within two years of the date of the royalty statement then they are forever foreclosed from challenging the accuracy of that statement. Thus, the artist who has a steady but modest stream of record sales will never be paid what he or she is actually due.

This system is made possible by contracts that essentially preclude any penalties for the underpayment of royalties. Each recording contract contains a clause which essentially states that the record company, no matter how egregious their behavior, will never be liable for more than the amount of royalties due, and will not have been deemed to breach the contract until a court determines the amount due and then only if the record companies fails to heed the courts order. While there is an exception for outright fraud, the artist must prove a specific intent to be fraudulent on the part of the record company. Specific intent is one of the hardest things to prove in court. Thus, the record company is free to be purposefully negligent in its royalty accounting without penalty.

The record company, no matter how bad their behavior, suffers no penalty for underpayment. Thus, there is incentive for the record company to play hide the ball. If they get caught there is no penalty. If they do not get caught, they get to keep the underpayment.

Two potential solutions have been proposed to remedy this situation. One is to legislatively confirm that the duty to pay royalties to a recording artist is a fiduciary duty. The other is to legislatively create penalties for a pattern and practice of underpayment of royalties.

Fiduciary Duty

Making the duty to pay royalties a fiduciary duty essentially means that the artist would have a moral right, in addition to the contractual right, to receive fair and accurate royalty statements and would have additional remedies available to them to enforce their rights, including, potentially having the contract end. Normally contractual relationships are not subject to fiduciary duties, the theory being that parties to contracts have other remedies, primarily the right to sue for breach of contract, available to them. There have been examples however, where contractual relationships have given rise to fiduciary duties. This would happen in a circumstance where one party has sole control over the information necessary to determine if there was a breach. If one enters into a contract to have a bathroom built in ones house, one has the means to inspect the job to find out if there is a breach. In the case of record contracts the record company has sole control over sales and accounting data. The artist has no easily accessible and independent means to judge whether or not the royalty statement is accurate or there is a breach. While there is a right to audit, it is an expensive and time consuming process and in most contracts is severely limited so as to make it incomplete at best. While the fiduciary duty has not been specifically held by courts to arise in recording contracts, the facts and circumstances of recording agreements suggest that the fiduciary relationship is applicable. This can easily be confirmed by simple legislation.

Record companies argue that artists and their representatives would use the fiduciary duty as a lever to wring more money out of the record company or ultimately to get out of the recording contract. While I am sure the more aggressive artist's representative or a very angry artist would attempt to do so, this approach would only work if the record company has engaged in deceitful behavior by not paying royalties due. In any case, the statute could easily be drafted to preclude claims of breach in frivolous claims or for insubstantial or immaterial breaches. The situation where the parties have good faith differences in interpretation of a clause in the contract could be addressed similarly.

Penalties

Another potential solution is to create statutory penalties for underpayment of royalties similar to bad faith provisions currently applicable to the insurance industry. The insurance industry relationship with an insured is very similar to the record companies' relationship with its royalty artists. The insurance company is contractually obligated to compensate its insured for their covered losses subject to the contract between the parties. The record companies are contractually obligated to pay royalties to the artist subject to the contract. In both cases, the parties may have different opinions as to the amount of compensation due. In the case of insurance companies, prior to the enactment of bad faith legislation, the insurance company would as a matter of course and policy, simply stonewall the insured by making low-ball offers to settle, requiring the insured to go to court to receive anything that resembles what the insured are rightfully due. The insured could rarely afford the costs or the time to go to court and was forced to settle for a fraction of the amount due.

The record contract, in the case of a dispute, similarly forces the artist to go to court to receive the full amount rightfully owed. To solve this problem, legislation was enacted calling for, in most cases, treble damages and attorneys' fees, if the insurance companies were found to have engaged in bad faith. In order to sustain the claim of bad faith the insured must first prove the claim in court and then the court must find that the insurance company acted in bad faith by improperly denying the claim or making a ridiculously low offer to settle. The threat of treble damages keeps the insurance companies honest. Few frivolous bad faith claims are made because it requires the insured to first prove their claim in court. If there truly is bad faith, the artist has incentive to pursue it because the treble damages cover the risk and cost of going to court. Again, good faith disagreements in interpretation are not grounds for a bad faith claim. This approach is also valuable because it has been in place for some time and most of the kinks have been worked out and the loopholes closed.

This would be an effective way to encourage record companies to accurately account while preventing artists from using these protections against the record companies in bad faith themselves.

There is also the question of what artists allege is systematic underreporting. Neither the fiduciary duty nor the bad faith provisions would protect artists from a system whereby, relatively small amounts in each individual case, but large amounts when aggregated are routinely underreported. Such is the case, when for the sake of efficiency; "royalty policies" are regularly substituted for contractual requirements. One would have to audit each and every royalty statement to receive the proper payment. When an artist earns stable but modest amounts that don't justify auditing, they will never be paid properly. A potential solution is to legislatively create a penalty of treble damages for those companies that routinely and systematically have a "pattern and practice" of underreporting royalties. Again, such a statute could be drafted to curtail its use in a frivolous manner by artists.

If, as record companies insist, they do not engage in the bad behavior as alleged by the artists, how can they oppose increased penalties for bad behavior?

Audits

Another reason artists have little confidence in the current royalty system are overbearing restrictions on the right to audit. The record companies have a legitimate interest in the time, place and manner of the conduct of audits in order to limit disruption of their business and to prevent frivolous use of the audit rights.

The purpose of an audit is to engender confidence in the royalty recipients that they are being accounted to properly by allowing them to check the figures they are being provided. If, as is the case in the recording industry, the right to audit is severely limited, then it cannot serve the purpose of instilling confidence and good will. Relaxation of these audit restrictions will cost record companies nothing, if, as they claim, their reporting is accurate. It will however instill confidence in the artists.

Almost all recording agreements prevent the artist from auditing manufacturing records, general ledger records or foreign records. Manufacturing records are the basis of every audit in the real world. Manufactured units less inventory units equals sales. This is auditing 101. Similarly, examination of the general ledger records verifies that the sales figures reported are the same as sales figures booked by the company in their internal accounting records. This lack of information coupled with the inability to see any records from foreign sales makes it absolutely impossible to verify sales figures upon which royalties are calculated. As such, the artist is forced to accept on faith that the sales figures reported by the record company are accurate. Therefore, the so-called right to audit in recording contracts is limited to attempting to ascertain whether or not the proper royalty rates are applied to the sales figures reported and which cannot independently be verified.

Additionally most recording agreements place limitations on who the artist can engage to perform an audit. The most problematic of these restrictions are the prohibition against hiring an auditor on a contingency fee basis and the prohibition against hiring an auditor who is also performing an audit of the same company on behalf of another artist. These restrictions serve to both drive up the costs of an audit and insure that an artist must put up a cash retainer in order to engage an auditor. Artist who earn modest royalties have to take a large gamble in deciding whether the cost of an audit is worth the risk in the context of how large the potential recovery might be. Only very successful artists can afford that gamble. As a result, it is impossible for an artist earning modest amounts to verify the accuracy of their royalty statements. These artists never get their due.

Assuming again, that the record companies generally account properly, relaxing these restrictions would not result in increased royalty payments. It would however result in a short term increase in the company's own audit related costs due to an increased number of audits.

The increase in such costs resulting from relaxing the prohibition against contingency audits would be offset by a reduction in costs by allowing one auditor to examine the records once on behalf of multiple artists.

In the last hearing, a record company executive testified that they settled all audit claims for an average of four percent of the claims. If this is true, than after an initial short term jump, the number of audits would revert back to its initial level because the audits would return little in recovery and would not be cost effective for the artists and their auditors.

As a result, record companies could actually reduce audit related costs by relaxing audit restrictions. They would also remove a major complaint of artists and create a better atmosphere for working together on other issues where their interests are aligned.

Structure

Underpinning all of this is the antiquated structure of the recording agreements. Recording agreements are outdated and unnecessarily complicated contracts which can be up to 80 pages long. Many of the clauses were first drafted in the early part of the last century when music was done on acetate or when a 78 rpm record shattered into pieces when dropped. Some of these clauses are irrelevant in today's music industry; others are just complete fictions. With corporate accounting scandals increasing daily, transparency is the order of the day. A more transparent and simple system would save money for the record companies by reducing royalty accounting costs. The numbers would easily be analyzed and verified and would provide goodwill with the artists by removing many of the issues which form the basis of claims in an audit.

For instance, almost all recording agreements contain a "packaging" or "container" deduction, calling for a reduction in the artist's royalties of between 15% and 25%. This is rooted in days when records were sold in brown paper sleeves and to have an actual cover with artwork created additional costs for the record company. A compact disc actually costs less than $1.00 to manufacture. Assuming a relatively low $15.00 suggested retail price and a 15% deduction, the artist is being charged $2.25 for the manufacture of a CD that costs $1.00 to make. In addition to paying for the recording and marketing of the CD, the artist is actually paying for its manufacture and providing a tidy profit to the record company in the process.

Many contracts today still have a reduction in royalties for compact discs. This is rooted in a time when compact discs were first introduced and cassette tapes and albums were the dominant formats. Because their volume was not high, it cost more to make a compact disc. Now of course, compact discs are the dominant format, few cassette tapes are sold and it is next to impossible to buy a vinyl album. This is clearly not relevant today.

There are also different royalty rates, sometimes expressed as a percentage royalty deduction for sales in foreign countries. This is rooted in the era where most record companies licensed the records to independently owned foreign distribution companies. Today, the five major music companies, which release well over 90% of commercial music all, have wholly owned subsidiaries handling distribution in foreign countries. These varying rates complicate matters unnecessarily and support a structure that no longer exists.

There is also a deduction for so-called "free goods". While this deduction has its origins in the practice of giving promotional copies to record stores, the giving of free goods today is just a way of giving the record store a price discount. The record company sells 85 records at $10.00 and gives away fifteen records as "free goods" receiving $850 for100 records. Rather than operate with this fiction, the record company could simply say that they sold 100 records for $8.50 each, arriving at the same revenue of $850.

Confusing matters more is that many of the record companies pay royalties on "Suggested Retail List Price" (slrp). This slrp is a complete fiction. Since record companies are all wholesalers of records, they receive payment at the wholesale price. It would be simpler just to pay royalties based on the wholesale price that is verifiable as the amount received by record company for the sale of the records.

These complicated structures are a haven for those who would purposely cheat artists. Auditors at our hearing on accounting practices told us that most of the "scams" used to cheat artists are rooted in how the various deductions are applied. The record industry should get rid of all of these deductions and pay a straight royalty. This change would cost the record company nothing. They would simple calculate the true net royalty and remove the deductions clauses. In addition to increased efficiency and accuracy of reporting, a streamlining of royalty provisions would remove potential areas of conflict and instantly take away many of the possible complaints by artists.

When questioned about this, record companies have responded that artist's representative don't want a streamlining because the representative and the artist would have to admit that their actual net royalty is actual 12 percent instead of the eighteen percent gross royalty. I posed this question to several top music lawyers and managers. All of them stated that with one or two superstar exceptions they have not been able to negotiate streamlined contracts with record companies. Further, they all said they would rather have the streamlined net royalty in the contract. Most of them use the net royalty when assessing the various contract points during a negotiation anyway.

CONCLUSION

The suggestions in this report would help solve many of the problems that exist between artist and record company. This would create a mutually beneficial atmosphere of trust that would create a strong industry to fight mutual enemies like illegal downloading.

I urge the record companies to consider the structural and accounting changes on their own to avoid legislative that would mandate contract terms and to engage in discussions with State Legislatures and Congress about enacting those suggestions that require legislative action.

It should be noted that BMG recently announced a streamlining of its royalty accounting system. BMG's announcement was however, almost, overshadowed by the conspicuous lack of interest by the other major record companies in following suit. BMG should be applauded for a move in the right direction. It remains to be seen, however, whether the new BMG contracts will really be an improvement for artists. Even if the royalty process is streamlined, without changes in the audit restrictions, the changes will ring hollow.

As this report was being prepared, an internal memo from UMG, the largest of the big five record companies surfaced which indicated intent on the part of UMG to both streamline royalties and eliminate audit restrictions. It was further reported that the impetus for such change was our State Senate hearings. The company has not yet affirmatively announced that it would implement those suggestions. However, assuming that it implements the memo, it would be a significant recognition by the largest company of the need to foster trust in their artists by making transparency a priority.

Of concern in the BMG announcement is their stated interest in participating in "additional revenue streams". An example of this new trend is the recently reported Robbie Williams contract with EMI, wherein they will participate in revenue streams other than records like music publishing, concerts and merchandising. While each artist and record company are free to make whatever arrangement they wish, it should be clear that artists should not have to sell interests in additional revenue streams in order to get the industry to provide fair and transparent contracts.

This industry should not revert back to the old practice of demanding interests in the artist's management, publishing and merchandising as a condition of obtaining a record contract. That would truly be a backward move toward indentured servitude.

Artists and record companies have so many interests where their interests are aligned. These include:

- Consolidation in the Radio Industry
- Independent Promotion Costs
- Public Performance Royalty for Broadcast Radio Play
- Extension of the Copyright Term
- Payments for Internet Streaming by Small Webcasters
- Protection of the First Amendment Rights of Music Artists.
- Protections against Piracy and Illegal Downloading
- Creation of New Business Models for Internet Distribution

After clearing up their conflicts, artists and record labels can work together to improve the industry for all concerned.

The Select Committee on the Entertainment Industry is committed to investigating and assisting in solutions for these issues.